62-SBE-049

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Appeals and Review Office
FRANCHISE TAX BOARD

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the matter of the Appeal of)
)
CERTIFIED GROCERS OF CALIFORNIA, LTD.)

Appearances:

For Appellant: Harry C. Williams and Martin J. Burke, Attorneys at Law

For Respondent: Burl D. Lack, Chief Counsel

O P I N I O N

This appeal is made pursuant to Section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Certified Grocers of California, Ltd., against proposed assessments of additional franchise tax in the amounts of $10,673.76, $13,356.96, $141,919.94, $157,267.63 and $160,868.96 for the income years ending October 31, 1953, 1954, 1955, 1956 and 1957, respectively.

Appellant is a cooperative corporation organized in 1925 under the provisions of the Corporations Code. It is a wholesale grocer, selling only to its members, some 1,000 or more retail grocers. Appellant's articles of incorporation state that it was organized for "the purpose of, and to facilitate, collective buying, in quantities of goods, wares, and merchandise at the lowest possible price with the intent and power to resell the same to its 'stockholders, members and to other persons...." In addition to its wholesale activity, Appellant operates a coffee roasting plant and a bean packaging facility.

Appellant is wholly owned by its member-patrons, each of whom holds ten shares of $20 par value common stock. (A small amount of preferred stock held by ten members was retired in 1956.) Members are entitled to one vote per share of common stock and they control Appellant's business through an elected board of directors.

The privileges of membership are conditioned not only upon the purchase of ten shares of common stock but also upon a cash deposit with Appellant of an amount equal to the member's average two weeks' purchases. These amounts, termed "required deposits" serve a two-fold purpose. They provide working

capital necessary for the acquisition of a large merchandise inventory, and they provide security for each member's purchases. If a member is unable to make the required cash deposit, his patronage dividends are retained until the necessary credit balance has been achieved. Any excess over the required amount is payable to the member on demand and the entire deposit is repayable upon termination of membership. Members may voluntarily deposit more than is required; these amounts, termed "excess deposits", are unconditionally payable on demand. Pursuant to a resolution adopted in 1948 by Appellant's Board of Directors, members received 3 percent interest on their required deposits during the years under review; those who made excess deposits received 5 percent interest until 1957 when the rate was increased to 6 percent. Members' required deposits averaged nearly $9,000,000 during the years under review while the capital accounts showed capital stock of $242,000 and earned surplus of $420,000.

Appellant buys products and commodities in large quantities, storing them in its own warehouses until they are sold to its retail grocer-members. At the time of sale, Appellant charges the prevailing market price for its goods. Twice each year the amount by which sales exceed Appellant's cost of goods sold, operating expenses and normal reserves, is computed and distributed to members according to their patronage. These "patronage dividends" are made under the mandatory provisions of Article VI of Appellant's bylaws which state:

> All earnings of the corporation, except such amounts as may be required for reserves for normal business requirements, as dictated by good accounting practice, and for the payment of dividends on preferred stock, shall be distributed uniformly to the shareholders of the association based in amount upon the volume of business transacted with the corporation by such shareholders.

During the years on appeal members were paid no distribution on the basis of their capital stock investment. On the theory that patronage dividends are merely price adjustments, Appellant has always excluded them from its gross income. Also, it deducted the amounts paid to members on their deposits as interest expense. The Franchise Tax Board determined that after 1954 Appellant could not exclude patronage dividends from taxable income nor was it ever entitled to deduct amounts paid to members on their deposits.

Patronage Dividends

Appellant contends that under a well established rule of law, it need not include in its taxable income amounts paid to its members as patronage dividends. Although there is no federal statute which expressly permits the exclusion of patronage

dividends from gross income, a practice of allowing such exclusions, under certain conditions, has long been followed by the Treasury Department. (T.D. 2737, June, 1918; I. T. 1499, I-2 Cum. Bull. 189 (1922); I. T. 3208, 1938-2 Cum. Bull. 127; Rev. Rul. 57-59, 1947-1 Cum. Bull. 24; Rev. Rul. 61-47, 1961-1 Cum. Bull. 193.)

> Under long established Bureau practice, amounts payable to patrons of cooperative corporations as so-called patronage dividends have been consistently excluded from the gross income of such corporations. The practice is based on the theory that such amounts in reality represent a reduction in cost to the patron of goods purchased by him through the corporation.... As such amounts are not includible in gross income of the corporation, they are obviously not deductible by it, though, where they have been erronously [sic] included in gross income in the first instance, the correcting adjustment is sometimes loosely termed a deduction. (I. T. 3208, supra.)

As recently as 1961, the Internal Revenue Service stated: "Thus, the true patronage dividend is treated as a corrective and deferred price adjustment, which serves to reduce the amount of the cooperative association's gross profit from sales." (Rev. Rul. 61-47, supra.)

The practice of excluding patronage dividends for federal income tax purposes has sometimes been referred to as a matter of "administrative grace" or "administrative liberality." As noted in Farmers Cooperative Co. v. Birmingham, 86 F. Supp. 201, 213, "use of such terminology makes for confusion, for it is obvious that no official of the Government is vested with the 'grace' or 'liberality' to exclude from a taxpayer's income that which is legally taxable to him under the federal income tax statutes." The propriety of this practice has been recognized and approved by the courts on numerous occasions. (Farmers Cooperative Co. v. Commissioner, 288 F. 2d 315, 317; Producers Gin Assoc., A.A.L., 33 T.C. 608, 612; Colony Farms Cooperative Dairy, Inc., 17 T.C. 688, 692; Anamosa Farmers Creamery Co., 13 B.T.A. 907, 908.) In Uniform Printing & Supply Co. v. Commissioner, 88 F. 2d 75, a corporation which returned all of its excess earnings to its stockholder-customers in proportion to the business they did with it was held not taxable on the amounts so returned. on the ground that they were refunds, not dividends. The court, at page 76, stated:

> Had the taxpayer given a customer (whether stock--, holder or outsider) a discount promptly after filling the order, no one would call it a dividend. If a rebate were given promptly upon the customer's

> business reaching a certain volume, the same conclusion as to its character would follow. To make cost estimates and adjust them at or near the end of each year returning the excess payment to the customer should not change the reasoning which leads to this conclusion. Nor should the fact that the customer is a stockholder materially affect the result.

The allocation of earnings by a cooperative to its patrons cannot qualify as a true patronage dividend unless three conditions are met: (1) the allocation is made pursuant to a legal obligation which existed at the time the participating patrons did business with the cooperative, (2) the allocation is made from profits realized on the business done with the particular patrons for whose benefit the allocation was made, and (3) the allocation is made ratably, according to the patronage of each participating patron. (Farmers Cooperative Co. v. Commissioner, supra; Pomeroy Cooperative Grain Co., 31 T.C. 674.) It is undisputed that the patronage refunds in question here fully comply with the above requirements and qualify as true patronage dividends within the meaning of the federal exclusionary rule.

While recognizing that the federal rule excluding patronage dividends from gross income is well established, the Franchise Tax Board contends that this rule is not the law of California.

At the time the California Bank and Corporation Franchise Tax Act was originally enacted in 1929, the Federal Revenue Act of 1928, section 103(12), provided that farmers, fruit growers, and like associations, operated on a cooperative basis, were entirely exempt from income tax if certain specified requirements were met. In making a similar provision, the California Legislature did not give a blanket exemption but rather permitted farmers, fruit growers, or like associations and other association5 operated on a cooperative basis, a deduction for all income from "business activities for or with their members, or with nonmembers, done on a nonprofit basis." (Bank and Corp. Franchise Tax Act, Section 8(k) and (l), Stats. 1929, p. 23.)

Citing Security-First National Bank v. Franchise Tax Board, 55 Cal. 2d 407, for the proposition that the California Supreme Court has ruled that patronage divdends are deductions rather than exclusions from gross income,.Respondent argues that by permitting cooperatives a deduction for all income arising from business for or with members, etc., the Legislature must have intended not to allow cooperatives any deductions without specific statutory authority. It urges that the Legislature obviously rejected the federal scheme of taxing cooperatives and that patronage dividends can only be deductions from gross income under the specific provisions of the Bank and Corporation Tax Law.

Respondent contends that prior to 1955 the section permitting cooperatives a deduction for income from business done for or with members, etc., (now Section 24405 of the Revenue and Taxation Code) was, in fact, the specific provision which authorized the deduction of patronage dividends. It concludes that the Legislature intended to deprive Appellant of its right to deduct patronage dividends when, in 1955, it amended Section 24405 so as to deny the benefits provided therein to "cooperative or mutual associations whose income is principally derived from the sale ... of tangible personal property other than agricultural products." (Stats. 1955, p. 2232.) This conclusion is based upon the Franchise Tax Board's determination that the goods Appellant customarily sells cannot be classed as "agricultural products."

We are of the opinion that the Franchise Tax Board is in error in its interpretation of the law of this State. In enacting the Bank and Corporation Franchise Tax Act of 1929, the Legislature defined gross income in substantially the same terms as found in the Federal Revenue Act of 1928, (See Section 22(a), Revenue Act of 1928; Calif. Stats. 1929, p. 20.) It is well settled that where legislation is framed in the language of an earlier enactment on the same or analogous subject, which has been judicially construed, there is a strong presumption that the Legislature intended to adopt the construction as well as the language of the prior enactment. (Union Oil Associates v. Johnson, 2 Cal. 2d 727, 734.) Comparing the California and federal definitions of gross income, this rule of construction was applied in Innes v. McColgan, 47 Cal. App. 2d 781, 784, wherein the court said: "we may presume that the California law was adopted with the definition in mind that the federal courts had placed on gross income."

The first Bureau of Intern&l Revenue ruling excluding patronage dividends from tax was issued in June of 1918. (T. D. 2737.) By the time the Bank and Corporation Franchise Tax Act was enacted in 1929, this administrative practice had been recognized by the federal courts. (Anamosa Farmers Creamery Co., 13 B.T.A. 907 (Oct. 16, 1928).) Thus, unless a contrary expression of the Legislature can be shown we must Presume that California intended to adopt the federal practice with regard to patronage dividends.

We cannot agree with the Franchise Tax Board's contention that subdivisions (k) and (l), Section 8 of the 1929 act were clearly intended to encompass the patronage dividend problem. The similarity of the language found in those provisions as compared to the federal provision exempting certain cooperatives from income tax indicates that subdivisions (k) and (1) of Section 8 were intended as the California equivalent of the cooperative exemption, except that income from business done on a profit basis with non-members was to be taxed. (See Section 103(12), Revenue Act of

1928.) This view is confirmed by the published comments of authors who assisted in drafting these measures. (McLaren and Butler, California Tax Laws of 1929, pp. 114-115.)

The question of the so-called "cooperative exemption" from federal income tax should not be confused with the question of the exclusion from a cooperative's gross income of "patronage dividends." (Farmers Cooperative Co. v. Birmingham, 86 F. Supp. 201, 206.) The former is an example of specific legislative grace completely sheltering certain associations from tax while the latter is the result of the application of well settled principles of law without any specific statutory authorization. While California chose not to completely exempt cooperatives from tax but rather allowed a deduction which, in effect, taxes all profits from business done with nonmembers, there is no logical basis for equating such a deduction with the practice of excluding patronage dividends. Subdivisions (k) and (1) of Section 8 permit the deduction of all income from business done with members and from business done with nonmembers on a nonprofit basis. Amounts paid as patronage dividends may be, and often are, something less than all income from member business, to say nothing of business with nonmembers on a nonprofit basis. Patronage dividends may amount to only a fractional part of the deductible income; thus, while such a deduction may include amounts which also might be excludable as patronage dividends, there is no necessary relation between the two. We are of the opinion that the adoption of subdivisions (k) and (1) of Section 8 cannot be construed as an expression of intent to deny cooperatives the benefit of the patronage dividend exclusionary rule. It follows, therefore, that subsequent amendments which merely limit the benefits granted under those provisions cannot affect the application of the patronage dividend principle.

The citation by Respondent of the California Supreme Court decision in Security-First National Bank v. Franchise Tax Board, 55 Cal. 2d 407, is, in light of the above discussion, inapposite. The court there dealt with the problem of the application of California's franchise tax to national banks. While its discussion did touch upon the tax treatment of cooperatives and the deduction permitted under Section 8, these comments have no relevance to the problem at hand unless it is assumed that in referring to said deduction the court intended to also refer to patronage dividends as *one* and the same thing. There is no basis in the opinion for such an assumption.

Interest Deductions

The Franchise Tax Board disallowed the deduction of amounts paid to Appellant's members on their required and excess deposits on the ground that such amounts were dividends rather than interest. We need not decide this issue in regard to the income

years ending October 31,1953 and 1954. Respondent's arguments in connection with patronage dividends make clear that until the 1955 amendment of Revenue and Taxation Code Section 24405 (formerly Section 8 (1) of the Act) Appellant was entitled to deduct all income arising from business done with its members. Since all of Appellant's income arose from business with its members and, accordingly, was not subject to tax, the allowance or disallowance of interest deductions for years prior to the amendment is immaterial.

The Franchise Tax Board contends that the advances made by Appellant's members in the form of required deposits were capital contributions placed at the risks of the venture and did not create bona fide indebtedness. Respondent's arguments revolve around two central points: the fact that required deposits, a condition of membership, were needed to finance Appellant's inventory and the fact that such deposits, which averaged nearly $9,000,000 for the years under review, greatly exceeded the capital accounts. It is urged that this latter circumstance demonstrates how "inadequately" Appellant was capitalized and is sufficient, alone, to support Respondent's determination.

The "essential difference between a creditor and a stockholder is that the latter intends to make an investment and take the risks of the venture, while the former seeks a definite obligation, payable in any event." (Commissioner v. Meridian & Thirteenth Realty Co., 132 F.2d 182, 186.) Whether certain transactions create debt or stock interests is a question of fact and each case must be adjudicated upon its own peculiar circumstances. While the courts have considered a number of factors in making their determinations, it is clear that no single test can be considered controlling or that even a rough rule of thumb may be confidently applied. (Wilbur Security Co. v. Commissioner, 279 F.2d 657, 662; Gokey Tie & Lbr. Co., Inc., 34 T.C. 829, 835, aff'd, 290 F.2d 870; Gooding Amusement Co. v. Commissioner, 236 F.2d 159, 165, cert. denied, 352 U.S. 1031; Leach Corp., 30 T.C. 563, 578; J. I. Morgan, Inc., 30 T.C. 881, 891.)

While in the past we have held that where a corporation is "thinly capitalized" the inference arises that part of the ostensible loans made by stockholders are in fact capital investments, we recognize that such a circumstance - standing alone - is not sufficient to automatically classify a debt as a sham. (Appeals of Agate Construction Co., et al., Cal. St. Bd. of Equal., March 7, 1961, 3 CCH Cal. Tax Cas. Par. 201-696, 2 P-H State & Local Tax Serv. Cal. Par. 13244; Leach Corp., supra; J. I. Morgan, Inc., supra.) Considering all of the circumstances of this case, it is our opinion that any adverse inference arising from an admittedly high "debt-equity" ratio is dispelled by a preponderance of factors in Appellant's favor.

We are impressed by the fact that required deposits lack the permanence generally associated with capital contributions. It appears that not only could members withdraw from Appellant at any time, taking back their entire deposits, but also members whose average two-week requirements may have diminished after the initial deposit was made could receive back the excess of such amount on demand without complete withdrawal from the association. Appellant states that it has, in fact, continually repaid deposits to members who have chosen to shift their patronage to some other competing cooperative. It is of course elementary that a right to the return of one's contribution has never been an attribute of stock ownership, except where the corporation is liquidated.

Furthermore, while each member has an equal voice in the management of Appellant's business, the size of the deposits required of each member vary as greatly as the needs of the smallest to the largest member. No reasonable businessman places large sums of money at the risk of an enterprise in which he has no more control than the smallest contributor.

It is important to note, also, that we are not dealing here with a closely held corporation in which the form of the relationships could easily be molded to create any desired facade. The 1,000 or more members of Appellant are engaged in a highly competitive activity and Appellant, itself, is competing for new members with other cooperative wholesalers. There is, therefore, no support for an assertion that Appellant's business with its members was ever conducted on anything other than an arms-length basis or that such members never really intended to enforce the rights they might have against Appellant.

The Franchise Tax Board alleges that required deposits must be considered capital contributions because they were used to perform a function usually performed by equity capital. The funds were used for the purchase of inventory, a current asset. In view of the fact that current assets are commonly financed by current debt, we find this argument unpersuasive. Furthermore, the use of the deposits as security is not characteristic of stock investments and establishes a sound business purpose for treating the deposits as debts.

We conclude that Appellant's required deposit arrangement did create bona fide indebtedness.

Much of what we have said with respect to the required deposits applies with equal or greater force to the excess deposits. These funds, which were deposited on a purely voluntary basis, were unconditionally payable on demand. There is no indication that repayment was ever refused. In view of our holding in regard to required deposits, further discussion is unnecessary to support our conclusion that the excess deposits also created debtor-creditor relationships.

Appeal of Certified Grocers of California, Ltd.

O R D E R

Pursuant to the views expressed in the Opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Certified Grocers of California, Ltd., against proposed assessments of additional franchise tax in the amounts of $10,673.76, $13,356.96, $141,919.94, $157,267.63 and $160,868.96, for the income years ending October 31, 1953, 1954, 1955, 1956 and 1957, respectively, be and the same is hereby reversed.

Done at Sacramento, California, this 20th day of September, 1962, by the State Board of Equalization.

Geo. R. Reilly, Chairman

John W. Lynch, Member

Paul R. Leake, Member

Richard Nevins, Member

_____, Member

ATTEST: Dixwell L. Pierce, Secretary